

repurchase premium is not deductible in the year of the repurchase, but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID.

(d) *Choice of accrual periods to determine whether a debt instrument is an applicable high yield discount obligation (AHYDO).* Section 163(e)(5) affects an issuer's OID deductions for certain high yield debt instruments that have significant OID. For purposes of section 163(i)(2), which defines significant OID, the issuer's choice of accrual periods to determine OID accruals is used to determine whether a debt instrument has significant OID. See § 1.1275-2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(e) *Qualified reopening—(1) In general.* In a qualified reopening of an issue of debt instruments, if a holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument, the issuer treats this difference as an adjustment to the issuer's interest expense for the original and additional debt instruments. As provided by paragraphs (e)(2) through (5) of this section, the adjustment is taken into account over the term of the instrument using constant yield principles.

(2) *Positive adjustment.* If the difference is positive (that is, the holder pays more than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference increases the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(3) *Negative adjustment.* If the difference is negative (that is, the holder pays less than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference reduces the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(4) *Determination of issuer's interest accruals.* As of the reopening date, the issuer must redetermine the yield of the debt instruments in the issue for purposes of applying the constant yield method described in § 1.1272-1(b) to determine the issuer's accruals of inter-

est expense over the remaining term of the debt instruments in the issue. This redetermined yield is based on the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) and the remaining payment schedule of the debt instruments in the issue. If the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) are less than the aggregate stated redemption price at maturity of the instruments (determined as of the reopening date) by a *de minimis* amount (within the meaning of § 1.1273-1(d)), the issuer may use the rules in paragraph (b) of this section to determine the issuer's accruals of interest expense.

(5) *Effect of adjustments on issuer's adjusted issue price.* The adjustments made under this paragraph (e) are taken into account for purposes of determining the issuer's adjusted issue price under § 1.1275-1(b).

(6) *Definitions.* The terms *additional debt instrument*, *original debt instrument*, *qualified reopening*, and *reopening date* have the same meanings as in § 1.1275-2(k).

(f) *Effective dates.* This section (other than paragraph (e) of this section) applies to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on this section (other than paragraph (e) of this section) for debt instruments issued after December 21, 1992, and before April 4, 1994. Paragraph (e) of this section applies to qualified reopenings where the reopening date is on or after March 13, 2001.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8934, 66 FR 2815, Jan. 12, 2001]

**§ 1.163-8T Allocation of interest expense among expenditures (temporary).**

(a) *In general—(1) Application.* This section prescribes rules for allocating interest expense for purposes of applying sections 469 (the "passive loss limitation") and 163 (d) and (h) (the "non-business interest limitations").

(2) *Cross-references.* This paragraph provides an overview of the manner in which interest expense is allocated for the purposes of applying the passive

loss limitation and nonbusiness interest limitations and the manner in which interest expense allocated under this section is treated. See paragraph (b) of this section for definitions of certain terms, paragraph (c) for the rules for allocating debt and interest expense among expenditures, paragraphs (d) and (e) for the treatment of debt repayments and refinancings, paragraph (j) for the rules for reallocating debt upon the occurrence of certain events, paragraph (m) for the coordination of the rules in this section with other limitations on the deductibility of interest expense, and paragraph (n) of this section for effective date and transitional rules.

(3) *Manner of allocation.* In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures.

(4) *Treatment of interest expenses—(i) General rule.* Except as otherwise provided in paragraph (m) of this section (relating to limitations on interest expense other than the passive loss and nonbusiness interest limitations), interest expense allocated under the rules of this section is treated in the following manner:

(A) Interest expense allocated to a trade or business expenditure (as defined in paragraph (b)(7) of this section) is taken into account under section 163(h)(2)(A);

(B) Interest expense allocated to a passive activity expenditure (as defined in paragraph (b)(4) of this section) or a former passive activity expenditure (as defined in paragraph (b)(2) of this section) is taken into account for purposes of section 469 in determining the income or loss from the activity to which such expenditure relates;

(C) Interest expense allocated to an investment expenditure (as defined in paragraph (b)(3) of this section) is treated for purposes of section 163(d) as investment interest;

(D) Interest expense allocated to a personal expenditure (as defined in paragraph (b)(5) of this section) is

treated for purposes of section 163(h) as personal interest; and

(E) Interest expense allocated to a portfolio expenditure (as defined in paragraph (b)(6) of this section) is treated for purposes of section 469(e)(2)(B)(ii) as interest expense described in section 469(e)(1)(A)(i)(III).

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(4):

*Example (1).* Taxpayer A, an individual, incurs interest expense allocated under the rules of this section to the following expenditures:

\$6,000 Passive activity expenditure.  
\$4,000 Personal expenditure.

The \$6,000 interest expense allocated to the passive activity expenditure is taken into account for purposes of section 469 in computing A's income or loss from the activity to which such interest relates. Pursuant to section 163(h), A may not deduct the \$4,000 interest expense allocated to the personal expenditure (except to the extent such interest is qualified residence interest, within the meaning of section 163(h)(3)).

*Example (2).* (i) Corporation M, a closely held C corporation (within the meaning of section 469(j)(1)) has \$10,000 of interest expense for a taxable year. Under the rules of this section, M's interest expense is allocated to the following expenditures:

\$2,000 Passive activity expenditure.  
\$3,000 Portfolio expenditure.  
\$5,000 Other expenditures.

(ii) Under section 163(d)(3)(D) and this paragraph (a)(4), the \$2,000 interest expense allocated to the passive activity expenditure is taken into account in computing M's passive activity loss for the taxable year, but, pursuant to section 469(e)(1) and this paragraph (a)(4), the interest expense allocated to the portfolio expenditure and the other expenditures is not taken into account for such purposes.

(iii) Since M is a closely held C corporation, its passive activity loss is allowable under section 469(e)(2)(A) as a deduction from net active income. Under section 469(e)(2)(B) and this paragraph (a)(4), the \$5,000 interest expense allocated to other expenditures is taken into account in computing M's net active income, but the interest expense allocated to the passive activity expenditure and the portfolio expenditure is not taken into account for such purposes.

(iv) Since M is a corporation, the \$3,000 interest expense allocated to the portfolio expenditure is allowable without regard to section 163(d). If M were an individual, however,

the interest expense allocated to the portfolio expenditure would be treated as investment interest for purposes of applying the limitation of section 163(d).

(b) *Definitions.* For purposes of this section—

(1) “Former passive activity” means an activity described in section 469(f)(3), but only if an unused deduction or credit (within the meaning of section 469(f)(1) (A) or (B)) is allocable to the activity under section 469(b) for the taxable year.

(2) “Former passive activity expenditure” means an expenditure that is taken into account under section 469 in computing the income or loss from a former passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible.

(3) “Investment expenditure” means an expenditure (other than a passive activity expenditure) properly chargeable to capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property.

(4) “Passive activity expenditure” means an expenditure that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible. For purposes of this section, the term “passive activity expenditure” does not include any expenditure with respect to any low-income housing project in any taxable year in which any benefit is allowed with respect to such project under section 502 of the Tax Reform Act of 1986.

(5) “Personal expenditure” means an expenditure that is not a trade or business expenditure, a passive activity expenditure, or an investment expenditure.

(6) “Portfolio expenditure” means an investment expenditure properly chargeable to capital account with respect to property producing income of a type described in section 469(e)(1)(A) or an investment expenditure for an ex-

pense clearly and directly allocable to such income.

(7) “Trade or business expenditure” means an expenditure (other than a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee.

(c) *Allocation of debt and interest expense*—(1) *Allocation in accordance with use of proceeds.* Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest. The following example illustrates the principles of this paragraph (c)(1):

*Example.* Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure to purchase the automobile even though the debt is secured by investment property.

(2) *Allocation period*—(i) *Allocation of debt.* Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used under the rules of this section to make the expenditure and ending on the earlier of—

(A) The date the debt is repaid; or

(B) The date the debt is reallocated in accordance with the rules in paragraphs (c)(4) and (j) of this section.

(ii) *Allocation of interest expense*—(A) *In general.* Except as otherwise provided in paragraph (m) of this section, interest expense accruing on a debt for any period is allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.

(B) *Effect of compounding.* Accrued interest is treated as a debt until it is

paid and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. For the taxable year in which a debt is reallocated under the rules in paragraphs (c)(4) and (j) of this section, however, compound interest accruing on such debt (other than compound interest accruing on interest that accrued before the beginning of the year) may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of 12 30-day months for purposes of allocating interest on a straight-line basis.

(C) *Accrual of interest expense.* For purposes of this paragraph (c)(2)(ii), the amount of interest expense that accrues during any period is determined by taking into account relevant provisions of the loan agreement and any applicable law such as sections 163(e), 483, and 1271 through 1275.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (c)(2):

*Example (1).* (i) On January 1, taxpayer B, a calendar year taxpayer, borrows \$1,000 at an interest rate of 11 percent, compounded semiannually. B immediately uses the debt proceeds to purchase an investment security. On July 1, B sells the investment security for \$1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the \$1,000 debt for the entire year.

(ii) Under this paragraph (c)(2) and paragraph (j) of this section, the \$1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the \$1,000 debt is allocated in ac-

cordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the \$55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional \$3 of interest expense for the period from July 1 through December 31 ( $\$55 \times .055$ ) is allocated to the investment expenditure. The remaining \$55 of interest expense for the period from July 1 through December 31 ( $\$1,000 \times .055$ ) is allocated to the passive activity expenditure.

(iii) Alternatively, under the rule in paragraph (c)(2)(ii)(B) of this section, B may allocate the interest expense on a straight-line basis and may also treat the year as consisting of 12 30-day months for this purpose. In that case, \$56.50 of interest expense ( $180/360 \times \$113$ ) would be allocated to the investment expenditure and the remaining \$56.50 of interest expense would be allocated to the passive activity expenditure.

*Example (2).* On January 1, 1988, taxpayer C borrows \$10,000 at an interest rate of 11 percent, compounded annually. All interest and principal on the debt is payable in a lump sum on December 31, 1992. C immediately uses the debt proceeds to make a passive activity expenditure. C materially participates in the activity in 1990, 1991, and 1992. Therefore, under paragraphs (c)(2) (i) and (j) of this section, the debt is allocated to a passive activity expenditure from January 1, 1988, through December 31, 1989, and to a former passive activity expenditure from January 1, 1990, through December 31, 1992. In accordance with the loan agreement (and consistent with § 1.1272-1(d)(1) of the proposed regulations, 51 FR 12022, April 8, 1986), interest expense accruing during any period is determined on the basis of annual compounding. Accordingly, the interest expense on the debt is allocated as follows:

Year	Amount		Expenditure
1988 .....	$\$10,000 \times .11$	\$1,100	Passive activity.
1989 .....	$11,100 \times .11$	1,221	Passive activity.
1990 .....	$12,321 \times .11 = 1,355$	.....	
	$1,355 \times 2,321/12,321$	255	Passive activity.
	$1,355 \times 10,000/12,321$	1,100	Former passive activity.
		1,355	
1991 .....	$13,676 \times .11 = 1,504$	.....	
	$1,504 \times 2,576/13,676$	283	Passive activity.
	$1,504 \times 11,100/13,676$	1,221	Former passive activity.
		1,504	
1992 .....	$15,180 \times .11 = 1,670$	.....	
	$1,670 \times 2,859/15,180$	315	Passive activity.

Year	Amount		Expenditure
	1,670 × 12,321/15,180	1,355	Former passive activity.
		1,670	

(3) *Allocation of debt; proceeds not disbursed to borrower*—(i) *Third-party financing*. If a lender disburses debt proceeds to a person other than the borrower in consideration for the sale or use of property, for services, or for any other purpose, the debt is treated for purposes of this section as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property, services, or other purpose.

(ii) *Debt assumptions not involving cash disbursements*. If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

(4) *Allocation of debt; proceeds deposited in borrower's account*—(i) *Treatment of deposit*. For purposes of this section, a deposit of debt proceeds in an account is treated as an investment expenditure, and amounts held in an account (whether or not interest bearing) are treated as property held for investment. Debt allocated to an account under this paragraph (c)(4)(i) must be reallocated as required by paragraph (j) of this section whenever debt proceeds held in the account are used for another expenditure. This paragraph (c)(4) provides rules for determining when debt proceeds are expended from the account. The following example illustrates the principles of this paragraph (c)(4)(i):

*Example*. Taxpayer C, a calendar year taxpayer, borrows \$100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, C uses \$20,000 of the debt proceeds

held in the account for a passive activity expenditure. On September 1, C uses an additional \$40,000 of the debt proceeds held in the account for a personal expenditure. Under this paragraph (c)(4)(i), from January 1 through March 31 the entire \$100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, \$20,000 of the debt is allocated to the passive activity expenditure, and \$80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, \$40,000 of the debt is allocated to the personal expenditure, \$20,000 is allocated to the passive activity expenditure, and \$40,000 is allocated to an investment expenditure for the account.

(ii) *Expenditures from account; general ordering rule*. Except as provided in paragraph (c)(4)(iii) (B) or (C) of this section, debt proceeds deposited in an account are treated as expended before—

(A) Any unborrowed amounts held in the account at the time such debt proceeds are deposited; and

(B) Any amounts (borrowed or unborrowed) that are deposited in the account after such debt proceeds are deposited.

The following example illustrates the application of this paragraph (c)(4)(ii):

*Example*. On January 10, taxpayer E opens a checking account, depositing \$500 of proceeds of Debt A and \$1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account:

Date	Transaction
Jan. 10 .....	\$500 proceeds of Debt A and \$1,000 unborrowed funds deposited.
Jan. 11 .....	\$500 proceeds of Debt B deposited.
Feb. 17 .....	\$800 personal expenditure.
Feb. 26 .....	\$700 passive activity expenditure.
June 21 .....	\$1,000 proceeds of Debt C deposited.
Nov. 24 .....	\$800 investment expenditure.
Dec. 20 .....	\$600 personal expenditure.

The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of the proceeds of Debt B. The \$700 passive activity expenditure is treated as made from the remaining \$200 proceeds of Debt B and \$500 of unborrowed funds. The \$800 investment expenditure is treated as made entirely from the proceeds of Debt C. The \$600

personal expenditure is treated as made from the remaining \$200 proceeds of Debt C and \$400 of unborrowed funds. Under paragraph (c)(4)(i) of this section, debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.

(iii) *Expenditures from account; supplemental ordering rules*—(A) *Checking or similar accounts.* Except as otherwise provided in this paragraph (c)(4)(iii), an expenditure from a checking or similar account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable period after the writing of the check. For this purpose, the taxpayer may treat checks written on the same day as written in any order. In the absence of evidence to the contrary, a check is presumed to be written on the date appearing on the check and to be delivered or mailed to the payee within a reasonable period thereafter. Evidence to the contrary may include the fact that a check does not clear within a reasonable period after the date appearing on the check.

(B) *Expenditures within 15 days after deposit of borrowed funds.* The taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof even if under paragraph (c)(4)(ii) of this section the debt proceeds would be treated as used to make one or more other expenditures. Any such expenditures and the debt proceeds from which such expenditures are treated as made are disregarded in applying paragraph (c)(4)(ii) of this section. The following examples illustrate the application of this paragraph (c)(4)(iii)(B):

*Example (1).* Taxpayer D incurs a \$1,000 debt on June 5 and immediately deposits the proceeds in an account (“Account A”). On June 17, D transfers \$2,000 from Account A to another account (“Account B”). On June 30, D writes a \$1,500 check on Account B for a passive activity expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat \$1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat \$1,000 of the passive activity expenditure on

June 30 as made from debt proceeds treated as deposited in Account B on June 17.

*Example (2).* The facts are the same as in the example in paragraph (c)(4)(ii) of this section, except that the proceeds of Debt B are deposited on February 11 rather than on January 11. Since the \$700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, E may treat such expenditure as being made from the proceeds of Debt B to the extent thereof. If E treats the passive activity expenditure in this manner, the expenditures from the account are treated as follows: The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of unborrowed funds. The \$700 passive activity expenditure is treated as made from the \$500 proceeds of Debt B and \$200 of unborrowed funds. The remaining expenditures are treated as in the example in paragraph (c)(4)(ii) of this section.

(C) *Interest on segregated account.* In the case of an account consisting solely of the proceeds of a debt and interest earned on such account, the taxpayer may treat any expenditure from such account as made first from amounts constituting interest (rather than debt proceeds) to the extent of the balance of such interest in the account at the time of the expenditure, determined by applying the rules in this paragraph (c)(4). To the extent any expenditure is treated as made from interest under this paragraph (c)(4)(iii)(C), the expenditure is disregarded in applying paragraph (c)(4)(ii) of this section.

(iv) *Optional method for determining date of reallocation.* Solely for the purpose of determining the date on which debt allocated to an account under paragraph (c)(4)(i) of this section is reallocated, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in the account as occurring on the later of the first day of such month or the date on which such debt proceeds are deposited in the account. This paragraph (c)(4)(iv) applies only if all expenditures from an account during the same calendar month are similarly treated. The following example illustrates the application of this paragraph (c)(4)(iv):

*Example.* On January 10, taxpayer G opens a checking account, depositing \$500 of proceeds of Debt A and \$1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account (note that these

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facts are the same as the facts of the example in paragraph (c)(4)(ii) of this section):

Date	Transaction
Jan. 10 .....	\$500 proceeds of Debt A and \$1,000 unborrowed funds deposited.
Jan. 11 .....	\$500 proceeds of Debt B deposited.
Feb. 17 .....	\$800 personal expenditure.
Feb. 26 .....	\$700 passive activity expenditure.
June 21 .....	\$1,000 proceeds of Debt C deposited.
Nov. 24 .....	\$800 investment expenditure.
Dec. 20 .....	\$600 personal expenditure.

Assume that G chooses to apply the optional rule of this paragraph (c)(4)(iv) to all expenditures. For purposes of determining the date on which debt is allocated to the \$800 personal expenditure made on February 17, the \$500 treated as made from the proceeds of Debt A and the \$300 treated as made from the proceeds of Debt B are treated as expenditures occurring on February 1. Accordingly, Debt A is allocated to an investment expenditure for the account from January 10 through January 31 and to the personal expenditure from February 1 through December 31, and \$300 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the personal expenditure from February 1 through December 31. The remaining \$200 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the passive activity expenditure from February 1 through December 31. The \$800 of Debt C used to make the investment expenditure on November 24 is allocated to an investment expenditure for the account from June 21 through October 31 and to an investment expenditure from November 1 through December 31. The remaining \$200 of Debt C is allocated to an investment expenditure for the account from June 21 through November 30 and to a personal expenditure from December 1 through December 31.

(v) *Simultaneous deposits*—(A) *In general.* If the proceeds of two or more debts are deposited in an account simultaneously, such proceeds are treated for purposes of this paragraph (c)(4) as deposited in the order in which the debts were incurred.

(B) *Order in which debts incurred.* If two or more debts are incurred simultaneously or are treated under applicable law as incurred simultaneously, the debts are treated for purposes of this paragraph (c)(4)(v) as incurred in any order the taxpayer selects.

(C) *Borrowings on which interest accrues at different rates.* If interest does not accrue at the same fixed or variable rate on the entire amount of a

borrowing, each portion of the borrowing on which interest accrues at a different fixed or variable rate is treated as a separate debt for purposes of this paragraph (c)(4)(v).

(vi) *Multiple accounts.* The rules in this paragraph (c)(4) apply separately to each account of a taxpayer.

(5) *Allocation of debt; proceeds received in cash*—(i) *Expenditure within 15 days of receiving debt proceeds.* If a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof and may treat such expenditure as made on the date the taxpayer received the cash. The following example illustrates the rule in this paragraph (c)(5)(i):

*Example.* Taxpayer F incurs a \$1,000 debt on August 4 and receives the debt proceeds in cash. F deposits \$1,500 cash in an account on August 15 and on August 27 writes a check on the account for a passive activity expenditure. In addition, F engages in numerous other cash transactions throughout the month of August, and numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to the account during the same period. Notwithstanding these other transactions, F may treat \$1,000 of the deposit on August 15 as an expenditure made from the debt proceeds on August 4. In addition, under the rule in paragraph (c)(4)(v)(B) of this section, F may treat the passive activity expenditure on August 27 as made from the \$1,000 debt proceeds treated as deposited in the account.

(ii) *Other expenditures.* Except as provided in paragraphs (c)(5) (i) and (iii) of this section, any debt proceeds a taxpayer (other than a corporation) receives in cash are treated as used to make personal expenditures. For purposes of this paragraph (c)(5), debt proceeds are received in cash if, for example, a withdrawal of cash from an account is treated under the rules of this section as an expenditure of debt proceeds.

(iii) *Special rules for certain taxpayers.* [Reserved]

(6) *Special rules*—(i) *Qualified residence debt.* [Reserved]

(ii) *Debt used to pay interest.* To the extent proceeds of a debt are used to pay interest, such debt is allocated in the same manner as the debt on which such interest accrued is allocated from

time to time. The following example illustrates the application of this paragraph (c)(6)(ii):

*Example.* On January 1, taxpayer H incurs a debt of \$1,000, bearing interest at an annual rate of 10 percent, compounded annually, payable at the end of each year (“Debt A”). H immediately opens a checking account, in which H deposits the proceeds of Debt A. No other amounts are deposited in the account during the year. On April 1, H writes a check for a personal expenditure in the amount of \$1,000. On December 31, H borrows \$100 (“Debt B”) and immediately uses the proceeds of Debt B to pay the accrued interest of \$100 on Debt A. From January 1 through March 31, Debt A is allocated, under the rule in paragraph (c)(4)(i) of this section, to the investment expenditure for the account. From April 1 through December 31, Debt A is allocated to the personal expenditure. Under the rule in paragraph (c)(2)(ii) of this section, \$25 of the interest on Debt A for the year is allocated to the investment expenditure, and \$75 of the interest on Debt A for the year is allocated to the personal expenditure. Accordingly, for the purpose of allocating the interest on Debt B for all periods until Debt B is repaid, \$25 of Debt B is allocated to the investment expenditure, and \$75 of Debt B is allocated to the personal expenditure.

(iii) *Debt used to pay borrowing costs—*

(A) *Borrowing costs with respect to different debt.* To the extent the proceeds of a debt (the “ancillary debt”) are used to pay borrowing costs (other than interest) with respect to another debt (the “primary debt”), the ancillary debt is allocated in the same manner as the primary debt is allocated from time to time. To the extent the primary debt is repaid, the ancillary debt will continue to be allocated in the same manner as the primary debt was allocated immediately before its repayment. The following example illustrates the rule in this paragraph (c)(6)(iii)(A):

*Example.* Taxpayer I incurs debts of \$60,000 (“Debt A”) and \$10,000 (“Debt B”). I immediately uses \$30,000 of the proceeds of Debt A to make a trade or business expenditure, \$20,000 to make a passive activity expenditure, and \$10,000 to make an investment expenditure. I immediately use \$3,000 of the proceeds of Debt B to pay borrowing costs (other than interest) with respect to Debt A (such as loan origination, loan commitment, abstract, and recording fees) and deposits the remaining \$7,000 in an account. Under the rule in this paragraph (c)(6)(iii)(A), the \$3,000

of Debt B used to pay expenses of incurring Debt A is allocated \$1,500 to the trade or business expenditure ( $\$3,000 \times \$30,000/\$60,000$ ), \$1,000 to the passive activity expenditure ( $\$3,000 \times \$20,000/\$60,000$ ), and \$500 ( $\$3,000 \times \$10,000/\$60,000$ ) to the investment expenditure. The manner in which the \$3,000 of Debt B used to pay expenses of incurring Debt A is allocated may change if the allocation of Debt A changes, but such allocation will be unaffected by any repayment of Debt A. The remaining \$7,000 of Debt B is allocated to an investment expenditure for the account until such time, if any, as this amount is used for a different expenditure.

(B) *Borrowing costs with respect to same debt.* To the extent the proceeds of a debt are used to pay borrowing costs (other than interest) with respect to such debt, such debt is allocated in the same manner as the remaining debt is allocated from time to time. The remaining debt for this purpose is the portion of the debt that is not used to pay borrowing costs (other than interest) with respect to such debt. Any repayment of the debt is treated as a repayment of the debt allocated under this paragraph (c)(6)(iii)(B) and the remaining debt is the same proportion as such amount bear to each other. The following example illustrates the application of this paragraph (c)(6)(iii)(B):

*Example.* (i) Taxpayer J borrows \$85,000. The lender disburses \$80,000 of this amount to J, retaining \$5,000 for borrowing costs (other than interest) with respect to the loan. J immediately uses \$40,000 of the debt proceeds to make a personal expenditure, \$20,000 to make a passive activity expenditure, and \$20,000 to make an investment expenditure. Under the rule in this paragraph (c)(6)(iii)(B), the \$5,000 used to pay borrowing costs is allocated \$2,500 ( $\$5,000 \times \$40,000/\$80,000$ ) to the personal expenditure, \$1,250 ( $\$5,000 \times \$20,000/\$80,000$ ) to the investment expenditure. The manner in which this \$5,000 is allocated may change if the allocation of the remaining \$80,000 of debt is changed.

(ii) Assume that J repays \$50,000 of the debt. The repayment is treated as a repayment of \$2,941 ( $\$50,000 \times \$5,000/\$85,000$ ) of the debt used to pay borrowing costs and a repayment of \$47,059 ( $\$50,000 \times \$80,000/\$85,000$ ) of the remaining debt. Under paragraph (d) of this section, J is treated as repaying the \$42,500 of debt allocated to the personal expenditure (\$2,500 of debt used to pay borrowing costs and \$40,000 of remaining debt). In addition, assuming that under paragraph (d)(2) J chooses to treat the allocation to the



passive activity expenditure as having occurred before the allocation to the investment expenditure, J is treated as repaying \$7,500 of debt allocated to the passive activity expenditure (\$441 of debt used to pay borrowing costs and \$7,059 of remaining debt).

(iv) *Allocation of debt before actual receipt of debt proceeds.* If interest properly accrues on a debt during any period before the debt proceeds are actually received or used to make an expenditure, the debt is allocated to an investment expenditure for such period.

(7) *Antiabuse rules.* [Reserved]

(d) *Debt repayments*—(1) *General ordering rule.* If, at the time any portion of a debt is repaid, such debt is allocated to more than one expenditure, the debt is treated for purposes of this section as repaid in the following order:

(i) Amounts allocated to personal expenditures;

(ii) Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in paragraph (d)(1)(iii) of this section);

(iii) Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i));

(iv) Amounts allocated to former passive activity expenditures; and

(v) Amounts allocated to trade or business expenditures and to expenditures described in the last sentence of paragraph (b)(4) of this section.

(2) *Supplemental ordering rules for expenditures in same class.* Amounts allocated to two or more expenditures that are described in the subdivision of paragraph (d)(1) of this section (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures. For purposes of this paragraph (d)(2), the taxpayer may treat allocations and reallocations that occur on the same day as occurring in any order (without regard to the order in which expenditures are treated as made under paragraph (c)(4)(iii)(A) of this section).

(3) *Continuous borrowings.* In the case of borrowings pursuant to a line of

credit or similar account or arrangement that allows a taxpayer to borrow funds periodically under a single loan agreement—

(i) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single debt; and

(ii) Borrowings or portions of borrowings on which interest accrues at different fixed or variable rates are treated as different debts, and such debts are treated as repaid for purposes of this paragraph (d) in the order in which such borrowings are treated as repaid under the loan agreement.

(4) *Examples.* The following examples illustrate the application of this paragraph (d):

*Example (1).* Taxpayer B borrows \$100,000 (“Debt A”) on July 12, immediately deposits the proceeds in an account, and uses the debt proceeds to make the following expenditures on the following dates:

August 31—\$40,000 passive activity expenditure #1.

October 5—\$20,000 passive activity expenditure #2.

December 24—\$40,000 personal expenditure.

On January 19 of the following year, B repays \$90,000 of Debt A (leaving \$10,000 of Debt A outstanding). The \$40,000 of Debt A allocated to the personal expenditure, the \$40,000 allocated to passive activity expenditure #1, and \$10,000 of the \$20,000 allocated to passive activity expenditure #2 are treated as repaid.

*Example (2).* (i) Taxpayer A obtains a line of credit. Interest on any borrowing on the line of credit accrues at the lender’s “prime lending rate” on the date of the borrowing plus two percentage points. The loan documents provide that borrowings on the line of credit are treated as repaid in the order the borrowings were made. A borrows \$30,000 (“Borrowing #1”) on the line of credit and immediately uses \$20,000 of the debt proceeds to make a personal expenditure (“personal expenditure #1”) and \$10,000 to make a trade or business expenditure (“trade or business expenditure #1”). A subsequently borrows another \$20,000 (“Borrowing #2”) on the line of credit and immediately uses \$15,000 of the debt proceeds to make a personal expenditure (“personal expenditure #2”) and \$5,000 to make a trade or business expenditure (“trade or business expenditure #2”). A then repays \$40,000 of the borrowings.

(ii) If the prime lending rate plus two percentage points was the same on both the date of Borrowing #1 and the date of Borrowing #2, the borrowings are treated for purposes of this paragraph (d) as a single debt, and A is treated as having repaid

\$35,000 of debt allocated to personal expenditure #1 and personal expenditure #2, and \$5,000 of debt allocated to trade or business expenditure #1.

(iii) If the prime lending rate plus two percentage points was different on the date of Borrowing #1 and Borrowing #2, the borrowings are treated as two debts, and, in accordance with the loan agreement, the \$40,000 repaid amount is treated as a repayment of Borrowing #1 and \$10,000 of Borrowing #2. Accordingly, A is treated as having repaid \$20,000 of debt allocated to personal expenditure #1, \$10,000 of debt allocated to trade or business expenditure #1, and \$10,000 of debt allocated to personal expenditure #2.

(e) *Debt refinancings*—(1) *In general.* To the extent proceeds of any debt (the “replacement debt”) are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditure that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section.

(2) *Example.* The following example illustrates the application of this paragraph (e):

*Example.* Taxpayer C borrows \$100,000 (“Debt A”) on July 12, immediately deposits the debt proceeds in an account, and uses the proceeds to make the following expenditures on the following dates (note that the facts of this example are the same as the facts of example (1) in paragraph (d)(4) of this section):

August 31—\$40,000 passive activity expenditure #1.

October 5—\$20,000 passive activity expenditure #2.

December 24—\$40,000 personal expenditure #1.

On January 19 of the following year, C borrows \$120,000 (“Debt B”) and uses \$90,000 of the proceeds to repay \$90,000 of Debt A (leaving \$10,000 of Debt A outstanding). In addition, C uses \$30,000 of the proceeds of Debt B to make a personal expenditure (“personal expenditure #2”). Debt B is allocated \$40,000 to personal expenditure #1, \$40,000 to passive activity expenditure #1, \$10,000 to passive activity expenditure #2, and \$30,000 to personal expenditure #2. Under paragraph (d)(1) of this section, Debt B will be treated as repaid in the following order: (1) amounts allocated

to personal expenditure #1, (2) amounts allocated to personal expenditure #2, (3) amounts allocated to passive activity expenditure #1, and (4) amounts allocated to passive activity expenditure #2.

(f) *Debt allocated to distributions by passthrough entities.* [Reserved]

(g) *Repayment of passthrough entity debt.* [Reserved]

(h) *Debt allocated to expenditures for interests in passthrough entities.* [Reserved]

(i) *Allocation of debt to loans between passthrough entities and interest holders.* [Reserved]

(j) *Reallocation of debt*—(1) *Debt allocated to capital expenditures*—(i) *Time of reallocation.* Except as provided in paragraph (j)(2) of this section, debt allocated to an expenditure properly chargeable to capital account with respect to an asset (the “first expenditure”) is reallocated to another expenditure on the earlier of—

(A) The date on which proceeds from a disposition of such asset are used for another expenditure; or

(B) The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

(ii) *Limitation on amount reallocated.* The amount of debt reallocated under paragraph (j)(1)(i)(A) of this section may not exceed the proceeds from the disposition of the asset. The amount of debt reallocated under paragraph (j)(1)(i)(B) of this section may not exceed the fair market value of the asset on the date of the change in use. In applying this paragraph (j)(1)(ii) with respect to a debt in any case in which two or more debts are allocable to expenditures properly chargeable to capital account with respect to the same asset, only a ratable portion (determined with respect to any such debt by dividing the amount of such debt by the aggregate amount of all such debts) of the fair market value or proceeds from the disposition of such asset shall be taken into account.

(iii) *Treatment of loans made by the taxpayer.* Except as provided in paragraph (j)(1)(iv) of this section, an expenditure to make a loan is treated as

an expenditure properly chargeable to capital account with respect to an asset, and for purposes of paragraph (j)(1)(i)(A) of this section any repayment of the loan is treated as a disposition of the asset. Paragraph (j)(3) of this section applies to any repayment of a loan in installments.

(iv) *Treatment of accounts.* Debt allocated to an account under paragraph (c)(4)(i) of this section is treated as allocated to an expenditure properly chargeable to capital account with respect to an asset, and any expenditure from the account is treated as a disposition of the asset. See paragraph (c)(4) of this section for rules under which debt proceeds allocated to an account are treated as used for another expenditure.

(2) *Disposition proceeds in excess of debt.* If the proceeds from the disposition of an asset exceed the amount of debt reallocated by reason of such disposition, or two or more debts are reallocated by reason of the disposition of an asset, the proceeds of the disposition are treated as an account to which the rules in paragraph (c)(4) of this section apply.

(3) *Special rule for deferred payment sales.* If any portion of the proceeds of a disposition of an asset are received subsequent to the disposition—

(i) The portion of the proceeds to be received subsequent to the disposition is treated for periods prior to the receipt as used to make an investment expenditure; and

(ii) Debt reallocated by reason of the disposition is allocated to such investment expenditure to the extent such debt exceeds the proceeds of the disposition previously received (other than proceeds used to repay such debt).

(4) *Examples.* The following examples illustrate the application of this paragraph (j):

*Example (1).* On January 1, 1988, taxpayer D sells an asset for \$25,000. Immediately before the sale, the amount of debt allocated to expenditures properly chargeable to capital account with respect to the asset was \$15,000. The proceeds of the disposition are treated as an account consisting of \$15,000 of debt proceeds and \$10,000 of unborrowed funds to which paragraph (c)(4) of this section applies. Thus, if D immediately makes a \$10,000 personal expenditure from the proceeds and within 15 days deposits the remaining pro-

ceeds in an account, D may, pursuant to paragraph (c)(4)(iii)(B) of this section, treat the entire \$15,000 deposited in the account as proceeds of a debt.

*Example (2).* The facts are the same as in example (1) except that, instead of receiving all \$25,000 of the sale proceeds on January 1, 1988, D receives 5,000 on that date, \$10,000 on January 1, 1989, and \$10,000 on January 1, 1990. D does not use any portion of the sale proceeds to repay the debt. Between January 1, 1988, and December 31, 1988, D is treated under paragraph (j)(3) of this section as making an investment expenditure of \$20,000 to which \$10,000 of debt is allocated. In addition, the remaining \$5,000 of debt is reallocated on January 1, 1988, in accordance with D's use of the sales proceeds received on that date. Between January 1, 1989, and December 31, 1989, D is treated as making an investment expenditure of \$10,000 to which no debt is allocated. In addition, as of January 1, 1989, \$10,000 of debt is reallocated in accordance with D's use of the sales proceeds received on that date.

*Example 3.* The facts are the same as in example (2), except that D immediately uses the \$5,000 sale proceeds received on January 1, 1988, to repay \$5,000 of the \$15,000 debt. Between January 1, 1988, and December 31, 1988, D is treated as making an investment expenditure of \$20,000 to which the remaining balance (\$10,000) of the debt is reallocated. The results in 1989 are as described in example (2).

(k) *Modification of rules in the case of interest expense allocated to foreign source income.* [Reserved]

(l) [Reserved]

(m) *Coordination with other provisions—(1) Effect of other limitations—(i) In general.* All debt is allocated among expenditures pursuant to the rules in this section, without regard to any limitations on the deductibility of interest expense on such debt. The applicability of the passive loss and nonbusiness interest limitations to interest on such debt, however, may be affected by other limitations on the deductibility of interest expense.

(ii) *Disallowance provisions.* (Interest expense that is not allowable as a deduction by reason of a disallowance provision (within the meaning of paragraph (m)(7)(ii) of this section) is not taken into account for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(iii) *Deferral provisions.* Interest expense that is not allowable as a deduction for the taxable year in which paid

or accrued by reason of a deferral provision (within the meaning of paragraph (m)(7)(iii) of this section) is allocated in the same manner as the debt giving rise to the interest expense is allocated for such taxable year. Such interest expense is taken into account for purposes of applying the passive loss and nonbusiness interest limitations for the taxable year in which such interest expense is allowable under such deferral provision.

(iv) *Capitalization provisions.* Interest expense that is capitalized pursuant to a capitalization provision (within the meaning of paragraph (m)(7)(i) of this section) is not taken into account as interest for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(2) *Effect on other limitations—(i) General rule.* Except as provided in paragraph (m)(2)(ii) of this section, any limitation on the deductibility of an item (other than the passive loss and nonbusiness interest limitations) applies without regard to the manner in which debt is allocated under this section. Thus, for example, interest expense treated under section 265(a)(2) as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax is not deductible regardless of the expenditure to which the underlying debt is allocated under this section.

(ii) *Exception.* Capitalization provisions (within the meaning of paragraph (m)(7)(i) of this section) do not apply to interest expense allocated to any personal expenditure under the rules of this section.

(3) *Qualified residence interest.* Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the rules of this section. In addition, qualified residence interest is not taken into account in determining the income or loss from any activity for purposes of section 469 or in determining the amount of investment interest for purposes of section 163(d). The following example illustrates the rule in this paragraph (m)(3):

*Example.* Taxpayer E, an individual, incurs a \$20,000 debt secured by a residence and immediately uses the proceeds to purchase an automobile exclusively for E's personal use. Under the rules in this section, the debt and interest expense on the debt are allocated to a personal expenditure. If, however, the interest on the debt is qualified residence interest within the meaning of section 163(h)(3), the interest is not treated as personal interest for purposes of section 163(h).

(4) *Interest described in section 163(h)(2)(E).* Interest described in section 163(h)(2)(E) is allowable as a deduction without regard to the rules of this section.

(5) *Interest on deemed distributee debt.* [Reserved]

(6) *Examples.* The following examples illustrate the relationship between the passive loss and nonbusiness interest limitations and other limitations on the deductibility of interest expense:

*Example (1).* Debt is allocated pursuant to the rules in this section to an investment expenditure for the purchase of taxable investment securities. Pursuant to section 265(a)(2), the debt is treated as indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax, and, accordingly, interest on the debt is disallowed. If section 265(a)(2) subsequently ceases to apply (because, for example, the taxpayer ceases to hold any tax-exempt obligations), and the debt at such time continues to be allocated to an investment expenditure, interest on the debt that accrues after such time is subject to section 163(d).

*Example (2).* An accrual method taxpayer incurs a debt payable to a cash method lender who is related to the taxpayer within the meaning of section 267(b). During the period in which interest on the debt is not deductible by reason of section 267(a)(2), the debt is allocated to a passive activity expenditure. Thus, interest that accrues on the debt for such period is also allocated to the passive activity expenditure. When such interest expense becomes deductible under section 267(a)(2), it will be allocated to the passive activity expenditure, regardless of how the debt is allocated at such time.

*Example (3).* A taxpayer incurs debt that is allocated under the rules of this section to an investment expenditure. Under section 263A(f), however, interest expense on such debt is capitalized during the production period (within the meaning of section 263A(f)(4)(B)) of property used in a passive activity of the taxpayer. The capitalized interest expense is not allocated to the investment expenditure, and depreciation deductions attributable to the capitalized interest

expense are subject to the passive loss limitation as long as the property is used in a passive activity. However, interest expense on the debt for periods after the production period is allocated to the investment expenditure as long as the debt remains allocated to the investment expenditure.

(7) *Other limitations on interest expense*—(i) *Capitalization provisions.* A capitalization provision is any provision that requires or allows interest expense to be capitalized. Capitalization provisions include sections 263(g), 263A(f), and 266.

(ii) *Disallowance provisions.* A disallowance provision is any provision (other than the passive loss and non-business interest limitations) that disallows a deduction for interest expense for all taxable years and is not a capitalization provision. Disallowance provisions include sections 163(f)(2), 264(a)(2), 264(a)(4), 265(a)(2), 265(b)(2), 279(a), 291(e)(1)(B)(ii), 805(b)(1), and 834(c)(5).

(iii) *Deferral provisions.* A deferral provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for any taxable year and is not a capitalization or disallowance provision. Deferral provisions include sections 267(a)(2), 465, 1277, and 1282.

(n) *Effective date*—(1) *In general.* This section applies to interest expense paid or accrued in taxable years beginning after December 31, 1986.

(2) *Transitional rule for certain expenditures.* For purposes of determining whether debt is allocated to expenditures made on or before August 3, 1987, paragraphs (c)(4)(iii)(B) and (c)(5)(i) of this section are applied by substituting “90 days” for “15 days.”

(3) *Transitional rule for certain debt*—

(i) *General rule.* Except as provided in paragraph (n)(3)(ii) of this section, any debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is treated for purposes of this section as debt allocated to expenditures properly chargeable to capital account with respect to the assets held for use or for sale to customers in such business or rental activity. Debt is properly attributable to a business or rental activity for purposes of this section (regardless of whether such debt otherwise would be

allocable under this section to expenditures in connection with such activity) if the taxpayer has properly and consistently deducted interest expense (including interest subject to limitation under section 163(d) as in effect prior to the Tax Reform Act of 1986) on such debt on Schedule C, E, or F of Form 1040 in computing income or loss from such business or rental activity for taxable years beginning before January 1, 1987. For purposes of this paragraph (n)(3), amended returns filed after July 2, 1987 are disregarded in determining whether a taxpayer has consistently deducted interest expense on Schedule C, E, or F of Form 1040 in computing income or loss from a business or rental activity.

(ii) *Exceptions*—(A) *Debt financed distributions by passthrough entities.* [Reserved]

(B) *Election out.* This paragraph (n)(3) does not apply with respect to debt of a taxpayer who elects under paragraph (n)(3) (viii) of this section to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) (i.e., in accordance with the use of the debt proceeds).

(iii) *Business or rental activity.* For purposes of this paragraph (n)(3), a business or rental activity is any trade or business or rental activity of the taxpayer. For this purpose—

(A) A trade or business includes a business or profession the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer’s share thereof) are properly reported on Schedule C, E, or F of Form 1040; and

(B) A rental activity includes an activity of renting property the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer’s share thereof) are properly reported on Schedule E of Form 1040.

(iv) *Example.* The following example illustrates the circumstances in which debt is properly attributable to a business or rental activity:

*Example.* Taxpayer H incurred a debt in 1979 and properly deducted the interest expense on the debt on Schedule C of Form 1040 for each year from 1979 through 1986. Under this paragraph (n) (3), the debt is properly

attributable to the business the results of which are reported on Schedule C.

(v) *Allocation requirement*—(A) *In general.* Debt outstanding on December 31, 1986, that is properly attributable (within the meaning of paragraph (n)(3)(i) of this section) to a business or rental activity must be allocated in a reasonable and consistent manner among the assets held for use or for sale to customers in such activity on the last day of the taxable year that includes December 31, 1986. The taxpayer shall specify the manner in which such debt is allocated by filing a statement in accordance with paragraph (n)(3)(vii) of this section. If the taxpayer does not file such a statement or fails to allocate such debt in a reasonable and consistent manner, the Commissioner shall allocate the debt.

(B) *Reasonable and consistent manner—examples of improper allocation.* For purposes of this paragraph (n)(3)(v), debt is not treated as allocated in a reasonable and consistent manner if—

(1) The amount of debt allocated to goodwill exceeds the basis of the goodwill; or

(2) The amount of debt allocated to an asset exceeds the fair market value of the asset, and the amount of debt allocated to any other asset is less than the fair market value (lesser of basis or fair market value in the case of goodwill) of such other asset.

(vi) *Coordination with other provisions.* The effect of any events occurring after the last day of the taxable year that includes December 31, 1986, shall be determined under the rules of this section, applied by treating the debt allocated to an asset under paragraph (n)(3)(v) of this section as if proceeds of such debt were used to make an expenditure properly chargeable to capital account with respect to such asset on the last day of the taxable year that includes December 31, 1986. Thus, debt that is allocated to an asset in accordance with this paragraph (n)(3) must be reallocated in accordance with paragraph (j) of this section upon the occurrence with respect to such asset of any event described in such paragraph (j). Similarly, such debt is treated as repaid in the order prescribed in paragraph (d) of this section. In addition, a

replacement debt (within the meaning of paragraph (e) of this section) is allocated to an expenditure properly chargeable to capital account with respect to an asset to the extent the proceeds of such debt are used to repay the portion of a debt allocated to such asset under this paragraph (n)(3).

(vii) *Form for allocation of debt.* A taxpayer shall allocate debt for purposes of this paragraph (n)(3) by attaching to the taxpayer's return for the first taxable year beginning after December 31, 1986, a statement that is prominently identified as a transitional allocation statement under §1.163-8T(n)(3) and includes the following information:

(A) A description of the business or rental activity to which the debt is properly attributable;

(B) The amount of debt allocated;

(C) The assets among which the debt is allocated;

(D) The manner in which the debt is allocated;

(E) The amount of debt allocated to each asset; and

(F) Such other information as the Commissioner may require.

(viii) *Form for election out.* A taxpayer shall elect to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) by attaching to the taxpayer's return (or amended return) for the first taxable year beginning after December 31, 1986, a statement to that effect, prominently identified as an election out under §1.163-8T(n)(3).

(ix) *Special rule for partnerships and S corporations.* For purposes of paragraph (n)(3)(ii)(B), (v), (vii) and (viii) of this section (relating to the allocation of debt and election out), a partnership or S corporation shall be treated as the taxpayer with respect to the debt of the partnership or S corporation.

(x) *Irrevocability.* An allocation or election filed in accordance with paragraph (n)(3) (vii) or (viii) of this section may not be revoked or modified except with the consent of the Commissioner.

[T.D. 8145, 52 FR 24999, July 2, 1987, as amended by T.D. 8145, 62 FR 40270, July 28, 1997]